Internal Revenue Service
memorandum
CC:TL:Br2
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date: OCT 1 1 1988

to: Regional Counsel, Mid-Atlantic Region CC:MA
Attn: Janet A. Engel, Special Trial Attorney

from: Director, Tax Litigation CC:TL

subject: [redacted]

This is in response to your memorandum, dated July 20, 1980, requesting technical advice on the following issue.

ISSUE

Whether a parent corporation that sells all of its stock, its voting preferred stock, in its subsidiary corporation must recapture as income any part of the losses of that subsidiary, which were previously utilized by the parent through its filing of consolidated tax returns with that subsidiary.

RECOMMENDATION

We recommend that the instant case be conceded.

FACTS

A corporation known as [redacted] was incorporated on [redacted]. From [redacted] through [redacted], [redacted] filed consolidated income tax returns with its parent, [redacted] (hereinafter [redacted]). [redacted] is owned and controlled by various members of the [redacted]. The stock of [redacted], which is entitled to one vote per share, was issued as follows in [redacted]:

1. Preferred Class A - [redacted] shares - $[redacted] capital

2. Common stock - [redacted] shares - $[redacted] capital

The preferred stock was limited and preferred as to dividends.

During the years [redacted] through [redacted], losses incurred by [redacted] were deducted in the consolidated returns filed by its parent, [redacted]. Such deducted losses were in excess of [redacted]'s basis in the preferred stock it held in [redacted].

[redacted] owned all of the Class A preferred stock, representing [redacted]% of the voting power of [redacted], but none of its common stock. [redacted] shares of the common stock, representing [redacted]% of the voting power, were held by [redacted] as Trustee of Settlement [redacted]. [redacted] shares of common stock, representing [redacted]% of the voting power were issued to various trusts for the benefit of parties who are not members of the [redacted].

On [redacted], [redacted] sold all of its preferred stock to Trust Number [redacted], now Trust [redacted]. The beneficiaries of this trust are [redacted] members. The sale price of the stock was $[redacted] per share plus accrued dividends. The total sales price was $[redacted]. [redacted], on its [redacted] return, reflected a capital gain on this transaction of $[redacted]. The basis of the stock was stated to be $[redacted], which was arrived at by adjusting the original basis of $[redacted] by a distribution received in the amount of $[redacted].

DISCUSSION

The problem presented by this case is whether the Government has any supportable theory for preventing the instant taxpayer, [redacted], from achieving what has been argued to be the practical equivalent of twice deriving a tax benefit for the losses of its subsidiary [redacted] incurred during the years [redacted] through [redacted]. [redacted] first derived tax benefit from those losses by offsetting its income during those years against those losses as a result of being allowed to file consolidated tax returns with [redacted] for the years [redacted] through [redacted]. [redacted] seeks in effect to derive a second tax benefit from those same losses by computing its gain on the sale of all of its preferred stock (in [redacted]) by availing itself of a basis in that stock unreduced by such losses.

The pertinent consolidated return rules for adjusting the basis of a corporation's investment in the preferred stock, it holds in another member of its affiliated group, are as follows.

Treas. Reg. § 1.1502-12(o) provides that "Basis shall be determined under § 1.1502-31 and § 1.1502-32 ...

Treas. Reg. § 1.1502-32 mandates an annual modification (either a "net positive adjustment" or a "net negative adjustment") with respect to the basis of each share of a member's stock in an amount equal to the difference between certain enumerated positive and negative adjustments. The applicable adjustments are classified according to whether the stock is not "limited and preferred as to dividends" ("common stock") or is so limited ("preferred stock"). The adjustments prescribed for preferred stock are computed first and are much more circumscribed than the common stock basis adjustments.

A positive adjustment for preferred stock is made only if there are preferred dividends in arrears, and is limited to the difference between: (i) the cumulative amount of dividends in arrears for post-1965 consolidated return years, and (ii) the subsidiary's accumulated earnings and profits as of the first day of the taxable year. Any remaining undistributed earnings and profits must be assigned to the basis of the common stock. This positive adjustment can never exceed the subsidiary's accumulated earnings and profits at the end of the taxable year. Treas. Reg. § 1.1502-32(c)(1) and § 1.1502-32(d)(1)(ii).

The first preferred stock negative adjustment is limited to distributions on preferred shares made out of earnings and profits accumulated in previous post-1965 consolidated return years. Treas. Reg. § 1.1502-32(c)(2)(i). However, this negative adjustment cannot exceed the positive preferred stock adjustments made for previous post-1965 consolidated return years (i.e., the total positive adjustments less total negative adjustments). Any preferred distribution which is greater than the permitted negative adjustment is deemed to be a distribution to the common shareholders. Treas. Reg. § 1.1502-32(c)(3). The second negative adjustment for preferred stock is for distributions made on or after August 9, 1979 out of earnings and profits accumulated in preaffiliation or separate-return-limitation years. Treas. Reg. § 1.1502-32(c)(2)(ii) and (iii).

Of particular importance, Treas. Reg. § 1.1502-32(d)(2) provides that any deficit in the earnings and profits of a subsidiary (i.e., a loss) for a taxable year shall be allocated among all the outstanding stock of such subsidiary which is not limited and preferred as to dividends. Clearly, this regulatory provision serves to exclude all deficits in earnings and profits from the negative adjustments to be made for preferred stock.

Section 1016 provides that a proper adjustment shall in all cases be made for expenditures, receipts, losses, or other items properly chargeable to capital account. Treas. Reg. § 1.1016-6(a) provides:

> Adjustments must always be made to eliminate double deductions or their equivalent. Thus,

> in the case of the stock of a subsidiary company, the basis thereof must be properly adjusted for the amount of the subsidiary company's losses for the years in which consolidated returns were made. (Underlying supplied).

Based upon Treas. Reg. § 1.1016-6(a), the Service has contended that a negative basis adjustment should be made with respect to [redacted]s preferred stock investment in [redacted] for the amount of [redacted]'s losses utilized by [redacted]. As support for that contention, the Service has relied upon two case precedents - Charles Ilfeld Company v. Hernandez, 292 U.S. 62 (1934) and Associated Telephone and Telegraph Company v. United States, 199 F.Supp. 452 (S.D. N.Y. 1961). The Service has asserted that double deductions or the equivalent of double deductions are precluded by the Supreme Court's holding in the Charles Ilfeld case and by Treas. Reg. § 1.1016-6(a). As such, the Service has argued that negative basis adjustments must be made in this case to prevent [redacted] from achieving what the Service has contended is the practical equivalent of a double deduction.

In the case of Woods Investment Company v. Commissioner, 85 T.C. 274 (1985), the issue was whether the parent corporation upon the sale of the stock of its subsidiaries must reduce its basis in that stock by the excess of accelerated depreciation over straight-line depreciation. There, the Tax Court held that what was acknowledged to be the practical equivalent of a double deduction was expressly mandated by the consolidated return regulations and I.R.C. § 312(k). On that basis, the Tax Court in Woods distinguished the Woods case from the Ilfeld case by noting that in Ilfeld the law (the Code) and the consolidated return regulations had not addressed the issue presented. In the instant case, however, the consolidated returns regulations did provide comprehensive and exclusive rules for making the proper basis adjustments to preferred stock and specifically provided that no basis adjustments will be made to the preferred stock of a subsidiary on account of the operating losses of that subsidiary. The Woods Court expressly responded to the Service's argument that a basis adjustment is required by the language of Treas. Reg. § 1.1016-6(a). It held that the general language of Treas. Reg. § 1.1016-6(a) (an interpretative regulation) must yield to a specific provision (a legislative regulation) listing the proper basis adjustments. In addition, the Woods Court pointed out that Treas. Reg. § 1.1016-6(a) requires a proper adjustment. Thus, the Woods Court concluded that such proper adjustments, as required by Treas. Reg. § 1.1016-6(a), were provided by Treas. Reg. § 1.1502-32 (determining basis adjustments based on earnings and profits.)

The Government has acquiesced to the Woods decision, without qualification, although it indicated it dislikes the result of that holding. Acq. 1986-1 C.B.-1 We believe that the Tax Court's response to Woods is equally applicable to this case. The "proper" adjustments to basis for preferred stock, as contemplated by Treas. Reg. § 1.1016-6(a) is spelled out quite clearly in Treas. Reg. § 1.1502-32(c) and (d). Accordingly, based on the Tax Court's holding in Woods and our acquiescence thereto, we believe that the instant case should be conceded.

The Ilfeld Co. case is distinguishable from the instant case. In Ilfeld Co., the Supreme Court disallowed the deduction of a corporation's loss on its investments in two subsidiaries, with which it had filed consolidated returns, upon the liquidation of the subsidiaries. The Supreme Court in Ilfeld determined that since there were no applicable regulations for those tax years to allow the deduction, the taxpayer should not be allowed one, because it had previously realized the benefit of offsetting the operating losses of the subsidiaries against its income without having reduced its basis in the stock of the subsidiaries. Moreover, the Supreme Court in Infeld stated that "in the absence of a provision in the Act or regulations that fairly may be read to authorize the deduction, the deduction claimed is not allowable." Ilfeld Co., supra at 66.

We believe that the comprehensive basis adjustment rules of Treas. Reg. § 1502-32(c) and Treas. Reg. § 1.1502-32(d)(2) quite specifically require that losses of a subsidiary will reduce the parent's basis in the stock of its subsidiary, which is not preferred stock, and will not reduce the parent's basis in the preferred stock of its subsidiary. Accordingly, such regulatory provisions can only be read as expressly precluding [redacted] from reducing the basis of its preferred stock in [redacted] by the operating losses of that subsidiary.

Likewise, the holding in Associated Telephone and Telegraph Co. v. United States (199 F.Supp. 452 (1961)) is distinguishable both from the Tax Court's holding in Woods Investment, supra and the instant case. The question presented by Associated Telephone, supra was whether the parent's basis for its common stock in its subsidiary must be adjusted downward to the extent of capital losses -- realized by its subsidiary and availed of by the parent corporation through filing a consolidated tax return-- for the purpose of determining the parent's loss on the subsequent sale of its subsidiary stock.

For the year at issue, 1954, in the Associated Telephone, supra case, the district court examined Treas. Reg. § 1.1502-34A, [which provision was replaced in 1966 by Treas. Reg. § 1.1502-

32]. Treas. Reg. § 1.1502-34A provided rules for determining the basis of a corporation's stock for the purpose for determining the basis of a corporation's stock in determining gain or loss. The District Court concluded that § 1.1502-34A merely provides basis rules with respect to losses other than capital losses and makes no reference at all to capital losses.1/ The District Court concluded that since no provision of the consolidated return regulations was applicable to the problem of the effect of capital losses on stock basis, it was thus proper to apply other applicable law. Accordingly, the District Court precluded the apparent double deduction in that case by invoking the rule of Treas. Reg. § 1.1016-6(a) requiring a basis adjustment to prevent a double deduction. The District Court responded to the argument: that a general provision of law, Treas. Reg. § 1.1016-6(a) must give way to a specific provision Treas. Reg. § 1.1502-34A, dealing with the same subject matter, by concluding that the argument was not applicable because no specific provision in Treas. Reg. § 1.1502-34A permitted the double deduction.

In both Woods Investments, supra, and the instant case, there are specific provisions allowing the "double deduction" (or the practical equivalent of a double deduction) sought by the taxpayers in those cases. In Woods Investment, the combined effect of Treas. Reg. § 1.1502-32(c) and section 312(k) provide specific rules with regard to the effect of accelerated depreciation on earnings and profits and such rules serve to allow the practical equivalent of a double deduction. In the instant case, Treas. Reg. § 1.1502-76(b)(1) allows each member who is permitted to join in filing a consolidated return (whether that member owns voting preferred or voting common stock) to utilize other members' losses (or income) to offset its own income (or losses). Yet, Treas. Reg. § 1.1502-32(c) and (d) specifically excludes deficits in earnings and profits (i.e., losses) from the items constituting the negative basis adjustments for preferred stock. Hence, the consolidated return provision Treas. Reg. § 1.1502-32 is a specific provision which allows [redacted] to claim a basis in the preferred stock of [redacted] unreduced in any way by the previously utilized losses of that subsidiary. The existence of a specific provision regarding the adjustment to basis at issue in Woods Investment and in the instant case make both cases distinguishable from the situations presented in Association Telephone and Telegraph, supra and Ilfeld, supra.

1/ Currently, Treas. Reg. § 1.1502-32(b)(2)(ii) expressly provides for negative adjustments for net capital losses incurred by the subsidiary in a prior separate return year as well as for consolidated capital losses incurred by the group in a prior consolidated return year, which are attributable to such subsidiary.

Finally, the rules of Treas. Reg. § 1.1502-32 that preclude negative basis adjustments to preferred stock with regard to a subsidiary's losses comports well with the true economic nature of preferred stock. That is, the losses of the subsidiary corporation are not borne by its preferred shareholders, but rather are borne entirely by its common shareholders. Accordingly, from purely an economic view the parent's basis in its preferred stock investment ought not to be adjusted to reflect the losses of a subsidiary.

On the other hand, allowing [redacted], solely on account of its voting preferred stock interest, in [redacted], to utilize [redacted]'s operating losses by being allowed to join with [redacted] in filing consolidated tax returns does run contrary to the economic character of [redacted]'s preferred stock investment in [redacted]. As a preferred shareholder, the value of [redacted]'s investment in [redacted] is, for the most part, unaffected by the operating losses of that subsidiary. Hence, as a pure economic matter [redacted] should not be treated as having shared in suffering the losses of [redacted].

This office, per a previous technical advice memorandum, had recommended that the Service make two arguments to preclude [redacted] from utilizing the losses of its subsidiaries in [redacted] through [redacted]. As a primary position, we recommended that [redacted] and the [redacted] subsidiaries are not an affiliated group for purposes of filing a consolidated tax return, because petitioner's acquisition of only voting preferred stock was without a business purpose, other than tax avoidance.

We recommended as a secondary argument that the Service contend that pursuant to section 269 petitioner is precluded from taking the loss deductions on the consolidated return and should not be permitted to file consolidated tax returns with its [redacted] subsidiaries, because the petitioner-parent had acquired voting control of the subsidiaries for the principal purpose of securing the subsidiaries' deductions.

These arguments are now precluded, because [redacted] obtained special legislation during [redacted]: (1) permitting it to file consolidated tax returns with its subsidiaries for all tax years beginning after [redacted] and ending before [redacted], and (2) precluding the Government from relying on section 269(or 482) or any principal of law to deny [redacted] the benefit of any losses incurred by the members of its affiliated group.

Accordingly, we conclude that the instant case should be conceded because the Service is precluded from denying [redacted] the use of the operating losses of [redacted] to offset its gains for the tax years [redacted] through [redacted] and because [redacted] in determining its gain (or loss) on the sale of its [redacted] preferred stock cannot be required to reduce its basis or otherwise recapture the previously utilized losses of its subsidiary, [redacted].

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